EFFECTS OF STATE REGULATION UPON THE MUNICIPAL OWNERSHIP MOVEMENT

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The policy of regulating public utilities by state commission may be said to have been inaugurated by Governor Hughes of New York and Senator La Follette of Wisconsin in 1907. Prior to that time there had been a good deal of agitation in the United States for municipal ownership and operation of street railways and other local utilities. The reports of successful municipal operation in Great Britain and Germany, coupled with intense dissatisfaction in many American cities with the results of private operation here, had made municipal ownership a nation-wide local issue. Mr. Hearst had come within a very few votes of being elected mayor of New York City on this issue, and Mr. Dunne had been elected mayor of Chicago on the definite platform of immediate municipal ownership and operation of street railways. The policy of regulation by state commissions, injected into American politics by the political prestige and constructive genius of Hughes and La Follette, and subsequently strengthened by the support of such strong progressive state executives as Woodrow Wilson in New Jersey and Hiram Johnson in California, has displayed more aggressive vitality than almost any other constructive political idea ever launched in state politics. In seven years' time this policy has swept across the country until now two-thirds of the states having large cities within their borders have established strong state commissions with regulatory powers.

The public control of public utilities is a problem of far-reaching and rapidly increasing importance, and that it will continue to be such a problem for an indefinite period in the future, cannot be questioned. The social, civic and political importance of the issue can hardly be over-estimated. Rapidly as cities are growing, and rapidly as their debts and expenditures are increasing, the activities and the investments of public utilities are increasing even more rapidly. Indeed, public utilities are coming to be what might be called the artificial natural environment of urban communities. They are, so to

speak, the second nature of cities. They supplement the sunshine and the air.

When the policy of state regulation was launched seven years ago, it received the cordial support of three classes of citizens: (1) those who were utterly opposed to municipal ownership, but who recognized either the necessity or the inevitableness of stringent public control; (2) those who were uncertain about municipal ownership and deemed it desirable to try the experiment of regulation, with the hope that it might succeed and thus make public ownership unnecessary; and (3) those who were definitely convinced that municipal ownership was desirable or necessary as an ultimate policy, but believed that regulation would be a good thing as a stop-gap while public opinion and public administration were getting ready for the inevitable. Influenced by these various hopes and expectations, the supporters of the new policy formed a somewhat motley political group. They included not all, but the major portion of, the progressive citizens of the country who desired to redeem the state and local governments from the domination of public service corporations.

At first the opposition to state regulation was made up primarily of three elements, viz., (1) the public service corporations, which were naturally hostile to a movement promising more minute and more rigid public control of their activities, and which, much as they disliked the interference of local governments and state legislatures, had by long practice learned how to meet these interferences and, therefore, preferred to keep on fighting in the old way rather than to face a new enemy and have to learn new tactics; (2) the corrupt and semi-corrupt political leaders and organizations which had acquired and maintained their power largely through their alliances with public service corporations under the old system of "give and take;" and (3) a comparatively small number of uncompromising municipal ownership men and municipal home rule advocates, together with a number of city politicians who had made political capital out of local feuds with the public service corporations. This third element of opposition manifested itself in spots where, through long local agitation, cities thought they were getting near the municipal ownership goal, or at least were getting into a position where they could, through franchise contracts and local regulation, secure better conditions as to rates and service, and where they feared that the sudden transfer of all powers of control to a state commission, subject

to the domination of state politics, would constitute a serious setback locally.

The sentiment of those who were definitely opposed to municipal ownership, and who welcomed regulation as a permanent solution of the problem of the control of public utilities, found remarkable expression only two years ago in the majority opinion of the supreme court of the state of Washington in the celebrated Seattle telephone case.[1] In this case the Washington court upheld an order of the state public service commission raising the rates of the independent telephone company in Seattle above the schedule fixed in the local franchise which had been granted by the city a few years before on the company's application and which had been subsequently accepted and used. In its enthusiasm for state commission regulation, the court said:

> In its search for remedies and while seriously considering municipal, state or government ownership, the public, by reference to the police power of the state, has almost unwittingly—unwittingly in the sense that it is not generally appreciated—solved the problem, and has, by the application of fundamental as well as established relative propositions of law, gained every advantage of ownership without assuming its burdens. . . . . The benefit of ownership is enjoyed, while its dangers—not the least of which are the political activities of great armies of public employes—are no longer a menace to those who, to avoid the hazards of public ownership, have unwillingly subscribed to the conditions prevailing before this and other states entered upon the policy of public control.

While the Washington commission and the Washington courts have gone further than most other commissions and courts in undermining the power of cities to control local utilities either by franchise contract or by ordinance, the aggressive sentiments just quoted give articulate expression to the general trend of commission and court opinion.

In the same case the Washington court forcibly defended the increase in the Seattle telephone rates, even though it involved the abrogation of the contract between the city and the company. "If we assume the right to lower rates to make the return conform to a fair interest rate upon a fair valuation," said the court,

> it follows that we must, in conscience, yield the right to those affected to petition for a rate, though it be higher than a present one, that will accomplish

[1] State ex. rel. Webster *vs.* Superior Court of King County, 67 Wash. 37, decided January 27, 1912.

the purpose of the law. These principles have their foundations laid deep in the doctrine of common honesty between man and man, between the public and its servants. They are sustained upon the theory that the public is willing to pay a full return and no more, a fair return and no less, to those who have lent their capital for its benefit. . . . . To hold that the public service commission is without jurisdiction to raise rates to the point of fairness, as it finds that point to be, would deprive the commission of the right to lower rates. To dissent from these views would be to hold that the state could not relieve the people of a municipality of an improvident contract, or one entered into in defiance of the will of the people, instances of which might be easily multiplied were we called upon to do so.

Largely as a result of the attitude assumed by the regulating authorities as set forth in the quotations just given, the line-up of forces on the political issue involved in state regulation of public utilities has considerably changed from what it was seven years ago. The public service corporations themselves, instead of being unanimously hostile to state regulation, as they were in 1907, have veered about until they appear to furnish the chief motive power behind the movement in those communities where state regulation has not yet been fully established. Doubtless the corporations have been and still are greatly annoyed by some of the positive or negative requirements of state commissions, and doubtless some corporations would gladly go back to the old system of haphazard regulation rather than submit to the systematic regulatory procedure now in vogue. Nevertheless, most corporations have come to see advantages in regulation itself and very great advantages in state as opposed to local regulation. By means of state regulation, they escape from the annoyance of local nagging and the immediate political pressure for lower rates, and appear to feel that they are stealing a march on the municipal ownership forces by a short cut across country. They expect to get so far out of sight of the municipal ownership movement that they hope never to see it again, or be seen by it.

On the other hand, it is fairly certain that the general public has been as unhappily disappointed in the general results of state regulation as the companies themselves have been happily disappointed. As in the case of the corporations, the extent and nature of this disappointment are not uniform either in time or place. Some commissions, as notably the Railroad Commission of California (which, however, does not have uniform jurisdiction over strictly local utilities), have borne down upon the corporations with a pretty firm

hand, and have thereby maintained their prestige with the people, while at the same time they have disarmed the opposition of the companies by the fairness of their severity. Generally speaking, however, the popular prestige of public service commissions is waning. The people are disappointed in the results obtained for the money spent, and a great many are coming to fear that the commissions as organs of government are primarily organs of the public utility interests to protect themselves from the mosquito-bites of rampant democracy. At the same time, there is a noticeable revival in the movement for municipal ownership and a strengthening of local resistance to the practical abrogation of municipal home rule as it relates to public utilities.

In order fairly to determine the underlying basis of fact or fancy for these changes in public sentiment and these shifting political alliances, we need to examine somewhat analytically the direct and indirect effects of state regulation upon municipal ownership as a business proposition.

Let us first consider the direct changes in the powers of cities to undertake municipal ownership, resulting from the enactment of public utility laws.

The Wisconsin law and the Wisconsin commission probably typify the state regulation movement as it exists in practice better than those of any other state. In certain respects, the Wisconsin law is still in advance of most of the other commission laws. This is particularly true with reference to the indeterminate franchise, which has been made to apply by legislative mandate to all of the public utilities operating in Wisconsin. This law, while not depriving the municipalities of the right to withhold their consent to the operation of public utilities in their midst, makes every franchise heretofore or hereafter granted a perpetual franchise subject to termination on one condition only, viz., that the municipality shall purchase the plant of the utility at a valuation to be fixed by the state commission. Under this law, the legal right of the municipalities to embark upon the policy of municipal ownership of local public utilities has been made universal, but the cities have been deprived of any right to build competing public utilities without the consent of the state commission or to acquire existing utilities by negotiations or under the terms of franchise contracts. For example, it would appear that no city in Wisconsin now has the authority to grant a franchise under

which the utility would be required to withdraw its capital out of earnings and transfer its property to the city at some future time without payment. No method of bringing about municipal ownership is contemplated except the single method of paying for the property a sum equal to its value as fixed at the time of its transfer by the state commission.

Under these conditions about a dozen public utilities have been acquired by municipalities in Wisconsin during the past seven years, but for the most part, these utilities are in small towns and represent a comparatively small investment. No street railways have as yet been taken over in Wisconsin under this law. It is too early to predict with certainty just what practical effect the Wisconsin indeterminate franchise plan will have upon the municipal ownership movement, but it is clear that it provides an inflexible procedure with no opportunity for adjustment to the varying conditions of different localities, and that a city cannot proceed to municipal ownership without submitting to the judgment of the state commission in fixing the price to be paid for the property, and the terms and conditions of the purchase, subject to appeal by either party to the courts. Moreover, without the consent of the state commission no city can build a plant of its own in competition with an existing private plant.

In California, where the right of municipal ownership and operation has been established by constitutional provision and where the control of local utilities remains for the most part in the hands of the local authorities, the state commission, nevertheless, has it within its power to hinder and possibly to prevent municipal ownership in particular cases by refusing its consent to the sale of a public utility to a city on the terms agreed upon between the parties.

In New York and New Jersey franchises granted by local authorities require the approval of the state commissions, and in New Jersey, when such franchises are approved, the state commission may impose its own conditions as to construction, equipment, maintenance or operation.

These illustrations show the tendency of the more radical state commission laws to check the freedom of the municipalities to advance toward municipal ownership in their own way. Some of the commission laws bring municipal undertakings under the control of the state commission practically to the same extent as private undertakings, and while such regulation is not necessarily inimical to municipal

ownership, it may, in some instances, make cities feel uncomfortably dependent upon the will of a state commission, which may be hostile politically or otherwise to the cities' aims.

This restriction and definition of the methods by which municipal ownership may be attained, and even the supervision of municipal undertakings by the state commissions, may in practice help rather than hinder the municipal ownership movement. But whether they help or hinder, it certainly cannot be claimed that the movement will be unaffected by them.

The indirect effects of state regulation upon the municipal ownership movement are even more numerous and important than the direct effects.

Except in those cases where perpetual franchises have been granted or where franchises have been granted binding the municipality to acquire the property at the expiration of the grant, public utility investments have not been legally recognized as permanent. The ultimate status of the investments has been more or less uncertain, but the definite limitation of a franchise has itself constituted a warning that the company ought to calculate upon getting its capital back out of earnings during the franchise period. Regulation assumes, however, that the investment is to be permanent, and, therefore, that the franchise-holding corporation has no reason for withdrawing its capital. Regulation assumes continuity and permanency, and is surprised and annoyed when the local authorities do anything to interfere with such continuity and permanency. Regulation does not even permit the companies to invest their earnings in extensions of plant, but practically requires that all such extensions shall be provided for from the proceeds of the sale of additional stocks and bonds. In this way, regulation often encourages the increase of the nominal capitalization of a utility. The general theory of regulation is that the capital investment shall grow with all improvements and extensions, and shall never be diminished except to the extent that property disappears or is withdrawn from use.

This theory is modified in certain cases to meet the actual requirements of local franchise contracts, as for example, in the city of New York, where the limited franchise now granted by the city authorities provides for the reversion of the fixed property located within the street limits to the municipality at the final expiration of the grant. In providing for the capitalization of the corporations

constructing plants under such franchises, the state commission requires that provision shall be made for the amortization of that portion of the investment which, at the expiration of the franchise, will be transferred to municipal ownership without payment, but no provision is made for the amortization of any of the property not fixed within the streets, whether or not its value is dependent upon its continued use in connection with a franchise. If, for example, a street railway is laid out so that a portion of its route lies on a private right of way, even though this private right of way may already have been placed on the city map as a future public street, the cost of the track laid on the private right of way is excluded from the amortization requirements. Moreover, if the franchise runs for a period of twenty-five years with an option for a renewal for a like period on a readjustment of the compensation paid for it, the commission bases its amortization requirements on the assumption that the franchise will be held for fifty years. Indeed, if the commission permitted the company to amortize its investment except to the extent that such investment represents property which will definitely pass out of the company's ownership and control at a fixed time, it would be permitting the company to pay for its property out of earnings derived from the public and still retain the property itself. It is for this reason that, in the absence of a definite, conclusive contract providing for the transfer of property to city ownership, regulating commissions will not look with favor upon the amortization of capital, unless they abandon the public point of view in an effort to "help out" the corporations.

The only contrary instance that has come to my attention is in the case of Fuhrmann *vs.* Cataract Power and Conduit Company, decided by the Public Service Commission for the second district of New York, April 2, 1913. This was a rate case. The company had been handling its amortization upon the theory that the life of its property would be equal to the term of its franchise, which would expire in 1932. The commission approved this general policy and authorized the company to withdraw from earnings from time to time an amount sufficient to complete the amortization of its depreciable property within the franchise period. The commission then called attention to the fact that at the expiration of the franchise the company would be the owner of a well-equipped plant in excellent operating condition which would have been fully paid for by the public.

The commission warned the city of Buffalo, as a franchise-granting authority, to jot this fact down in its notebook for reference in 1932, with the suggestion that, should the franchise be renewed, the company would not be entitled to a return which would enable it to amortize this property all over again. By a curious piece of reasoning, however, the commission intimated that, although the property would have been paid for by the public, the company, under a renewal of its franchise, would still be entitled to the regular fair return for the use of the property. This exceptional instance shows that, where regulation departs from the general theory above set forth, the result is still advantageous to the company and disadvantageous to the public.

One of the ways in which state regulation indirectly affects the municipal ownership movement is by the control over public utility construction accounts and capitalization exercised by state commissions. It is not easy to predict either the nature or the extent of this effect. So far as state regulation of stock and bond issues results in the actual squeezing out of water from the existing capitalization of a company or in keeping water out of future capitalization, it would appear that regulation must tend to make municipalization easier rather than more difficult. On the other hand, the extent to which the sanction of the state commission has the effect of bolstering up existing over-capitalization or of putting the state's guaranty upon new capitalization which in the course of time may come to be out of proportion to the real value of the depreciated plant, just so far will regulation tend to make the purchase of public utilities by cities difficult and burdensome. The ruling of the United States supreme court in the Consolidated Gas case to the effect that franchise values, once capitalized with the consent of the public authorities of a state, become an inviolable portion of the capital investment of a company, upon which it is entitled to earn a fair return the same as on its tangible assets, makes it extremely important that public regulating bodies should exercise the utmost care in approving capitalization, lest it be found that such approval, though improvidently given, be interpreted by the courts as a final guaranty both for future rate and service regulation and for purchase.

The right of the state commission to fix the value of a public utility property for the purpose of municipal purchase, whether directly as under the Wisconsin law or indirectly through the prior

approval of stock and bond issues, goes to the very core of the municipal ownership problem. Only a few years ago, constitutional and statutory restrictions, or the mere absence of delegated power, constituted a serious legal obstacle to the general acquisition of public utilities in most states and cities. This legal obstacle is gradually being removed, and we may confidently expect that in the near future the abstract right of cities to own and operate public utilities will be all but universally recognized in the United States. The next important obstacle in the way of the actual realization of the municipal ownership policy is the contractual relations existing between the cities and private corporations under franchises already granted. So far as the indeterminate franchise principle is applied, this obstacle will be wholly removed, and wherever the limited term franchise applies, it will be removed as the franchises expire. Even where unlimited or perpetual franchises have been granted, this obstacle is being overcome in some cases, and may be overcome in all, by the enactment of laws conferring upon the cities the right to take over public utilities by condemnation proceedings. The third great obstacle, which is of much more permanent practical importance than the other two, is the financial difficulty of paying for the property either out of taxes or out of earnings, with the temporary assistance of municipal credit. The purchase price of the utility is bound to be the sticking point. If the price can be beaten down low enough, the movement for municipal ownership will thereby receive a great impetus. If, on the other hand, the price can be beaten up high enough, the movement will suffer a corresponding check. Both from the standpoint of the city and from the standpoint of the corporation, the desirability or undesirability of municipalization in any particular case will largely be a matter of the price. The action of the regulating commissions, therefore, in substantially guaranteeing investments and capitalization in advance of the determination of the purchase price is bound to exercise a far-reaching though indirect effect upon the municipal ownership movement.

Valuations have come to be the big thing in the public utility world. Though for the present these valuations are usually made to serve as a basis for rate regulation, it is clear from the attitude of the courts that still higher valuations would be required in many cases as a basis for municipal purchase. In the play for advantages in the regulatory system now being established, the public service corpo-

rations have not been slow to see the critical importance of the valuation. Accordingly, all their ingenuity, power and influence, direct and indirect, are being brought to bear upon the problem of discovering new elements of value, and of persuading or coercing the commissions and the courts to recognize them. In this way, the almost inevitable trend of valuations is upward. Commissions, both out of the desire to be fair and even liberal to the companies, and also out of fear that their decisions may be upset by the courts, are continually giving the benefit of the doubt in valuation cases to the corporations owning the property. It seems reasonably certain, therefore, that, while the most scandalous abuses in capitalization will be corrected by means of regulation, nevertheless the recognized value of the actual property will be gradually swollen until it includes every conceivable element of "overhead charges" so-called, with certain additions thrown in for good measure. This tendency is the more inevitable because the commissions usually make their valuations as a basis for rate fixing, and the rate of return allowed on capital investment is a much simpler element of the problem than the valuation itself. Therefore, it is much easier for public opinion to force the rate of return down, say from 10 per cent to 8 per cent, or from 7 per cent to 6 per cent, than it would be to effect a corresponding reduction in the recognized capital value.

The possible effect of this double tendency upon the municipal ownership movement can be readily seen. Under the theory of the permanency of the investment usually recognized by the state commissions, no provision will be allowed for the amortization or retirement of the capital except such as is included under so-called "general amortization," which is nothing more than provision for the replacement of the property when it is worn out or obsolete. But when the city comes to take over a utility or proposes to enter into a contract by which the utility shall be made to pay for itself pending its transfer to public ownership, it is apparent that the rates, which have been scaled down without any provision for the amortization of the capital, may have to be increased again in order to take care of this new factor. If this should prove to be the case, the movement for municipalization would lose much of its political driving power. There is reason to believe that the average citizen who favors municipal ownership is still moved primarily by the expectation that under it he would secure better service, or lower rates, or both, and if it became clear that

in order to make municipal ownership successful, the rates would have to be raised, it is more than likely that the citizen's enthusiasm for the change would cool off rapidly.

Clearly, the effect of any system of regulation upon the movement for municipal ownership must be considered very carefully from the point of view assumed relative to the permanency of the investment, the guaranty of capital value and the limitation of rates. If public regulation says that the utilities are here to stay and we need never pay for them, and fixes values and rates accordingly, then the munic ipal ownership movement, when it comes along, will have an additional obstacle to overcome; for all *public* improvements have to be paid for either out of earnings or out of taxes. The danger of making public utility rates so low as to hinder municipalization is not limited to the activities of state commissions, however. The same result may be brought about by local regulation or even by franchise contract. It is quite conceivable, for example, that the Cleveland plan of automatic rate regulation will result in holding street-car fares down to so low a point that it would be entirely impossible for the city to maintain the same fares under municipal ownership while retiring the capital out of earnings.

One of the most effective arguments in favor of state regulation of public utilities is the fact that, under modern conditions, comparatively few utilities are confined within the physical limits of a single municipality, while many utilities have spread themselves over numerous municipalities, and some have become state-wide or even interstate in their ramifications. It is said that every utility should be operated as a unit and that the attempt to regulate it in geographical sub-divisions by several independent local authorities is illogical and impossible. Obviously, this argument has even greater weight against municipal ownership and operation than it has against local regulation. In so far, therefore, as state regulation represents a triumph of the unified operation idea as opposed to the geographical sub-division idea, it makes municipalization logically and practically more difficult. While various municipalities are actively engaged in regulating the operations of a utility within their respective limits, it is not hard to see how they could severally take over the utility, making such mutual agreements and concessions as might be necessary to enable them to operate it. But when the very idea of local control has been abandoned in favor of unified state control, the difficulty that would be

encountered in reviving the belief in the possibility of independent municipal operation is sufficiently obvious.

As a further incidental result of the transfer of regulatory powers from the local authorities to state commissions, there comes an atrophy of the municipal organs previously engaged in regulatory efforts, which are naturally the very organs to be developed into more active functioning if the utility is to be taken over for municipal operation. In other words, if the regulation of public utilities is taken out of the hands of the cities, the very activities which might gradually prepare the cities for the responsibilities of ownership and operation are prevented, with the result that the city is likely to become less fit as time goes on for the enlargement of its functions. In brief, state regulation is likely to result in a case of arrested development so far as the municipality is concerned.

Another way in which state regulation is likely to have a tendency to check the municipal ownership movement is in the creation of a powerful organ of government, state-wide in its ramifications and interests, which, like all established organs of government, straightway develops a strong instinct of self-preservation and self-perpetuation. To the state commission, a movement for municipal ownership in general or in a particular locality spells an indictment of the commission's success as a regulating body, and also means the curtailment of its functions and influence in the future. For these reasons, it is clear that, on the whole, the commissions, with all their tremendous power over legislation, politics and finance, will be actively or passively hostile to the municipalization of utilities under their jurisdiction. This hostility may not manifest itself in unimportant cases and may not even be manifested openly in very important cases. But that such hostility should exist and make itself felt in a general way, is, I think, an inevitable result of the constitution of human nature as we know it in American politics.

There are some reasons on the other hand for expecting that state regulation will hasten rather than hinder the municipal ownership movement. In so far as regulation is effective it will result in the training of a large body of technical men to look at public utility problems from the public point of view. This development will make the municipalization of public utilities more practicable and the success of municipal operation more likely. From this point of view, regulation is merely training men for the more direct and far-reach-

ing responsibilities of public ownership and operation. Moreover, in so far as regulation is effective, it will eliminate the speculative element from public utility investments and thereby drive out of the field a great many gamblers who are seeking to make personal fortunes through the exploitation of public privileges. It is from them that the bitterest and most dogged resistance to municipalization now comes. With the steadying down of the business so that no one can have any hope of receiving more than a just reward for a just service rendered, many of the public utility magnates will get tired of the game, and there may be a great accession to the ranks of the municipal ownership enthusiasts from those of the promoters who would be glad to sell at the best price possible and withdraw to other fields. It is further to be expected that the public knowledge which comes from uniform, accurate and detailed publicity will make municipal ownership more feasible and private ownership less alluring than heretofore.

It is possible that state regulation, through its failures, may result in greatly strengthening the demand for municipal ownership at the same time that it puts new obstacles in its way. If this proves to be true, we shall have a repetition of the many lamentable experiences of the past in American cities where it has often been found that the people, though in favor of a particular policy by a great majority, are helpless to put it into effect, with the result that political discontent, cynicism and civic paralysis ensue.

Perhaps one of the most likely effects of state regulation will be to enlarge the ambitions of the state itself and to create a strong movement in favor of state ownership of the inter-municipal utilities such as interurban railways, water power developments and transmission lines. In several respects, a movement for *state* ownership of utilities not strictly local in their character would not be handicapped by the tendencies of state regulation to the same extent that the movement for *municipal* ownership of even strictly local utilities might be so handicapped.